

**DEPARTMENT OF STATE REVENUE**

LETTER OF FINDINGS NUMBER: 98-0142

INCOME TAX

FOR TAX PERIODS: 1994

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**Issues**

**1. Income Tax:** Imposition of Gross Income Tax

**Authority:** IC 6-2.1-2-2, IC 6-2.1-1-2 (c), IC 6-8.2-5 (b), 26 USCA 707 (a) (2) (B), 26 CFR Sec. 1 707-3(c), (d), Gross Income Tax Division v. National Bank and Trust Co., (1948) 226 Ind. 298, 79 N.E. 2d 651.

The taxpayer protests the imposition of Gross Income Tax on certain receipts.

**2. Tax Administration:** Penalty

**Authority:** IC 6-8.1-10-2.1, 45 IAC 2.2-3-16.

Taxpayer protests the imposition of penalty.

**Statement of Facts**

The taxpayer, an operator of retail clothing stores, files a consolidated return which includes several related retail clothing stores. After a routine audit, the Indiana Department of Revenue assessed income tax, interest and penalty against the taxpayer. The taxpayer timely protested the assessment and a hearing was subsequently held. Further facts will be provided as necessary.

## **1. Income Tax: Imposition of Gross Income Tax**

### **Discussion**

Indiana imposes a gross income tax on the receipt of gross income pursuant to the provisions of IC 6-2.1-2-2 as follows:

- (a) An income tax, known as the gross income tax, is imposed upon the receipt of:

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- (2) the taxable gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident or domiciliary of Indiana.

An exclusion from the gross income tax is provided at IC 6-2.1-1-2 (c) as follows:

The term "gross income" does not include:

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- (14) The receipt of capital by a corporation, partnership, firm, or joint venture from the sale of stock or shares in such corporation, partnership, firm, or joint venture, or contributions to capital thereof. . . ."

This statute is further explained at 45 IAC 1-1-58 as follows:

Contributions of capital to a corporation, joint venture or partnership are exempt from gross income tax. No gross receipts result to the recipient of the capital and none result to the donee upon his receipt of stock in exchange for the capital.

Indiana Department of Revenue assessments are presumed to be correct and the taxpayer bears the burden of proving that an assessment is incorrect. IC 6-8.1-5-1 (b). All exemptions must be strictly construed against the party claiming the exemption. Gross Income Tax Division v. National Bank and Trust Co., (1948) 226 Ind. 298, 79 N.E. 2d 651.

The taxpayer, and two other corporations, corporation "A" and corporation "B", contracted to transfer assets to a limited partnership. The taxpayer and corporations "A" and "B" received cash from the limited partnership as a result of the transfer. The Indiana Department of Revenue assessed gross income tax against the total amount received by the taxpayer in the transaction. The taxpayer contends that the receipts are not subject to the gross income tax because they were received in exchange for a contribution of capital. The issue to be determined is whether the taxpayer's receipts were taxable gross income or nontaxable contributions of capital.

Pursuant to the law and regulation, contributions of capital do not result in gross income to either the recipient of the capital or the contributor. Therefore, the taxpayer is correct when saying that if the transfers were contributions of capital to a partnership, the monies received in exchange for those capital contributions would not be subject to gross income tax. The facts in this instance, however, do not support the conclusion that the situation under examination was in reality a contribution of capital.

Rather, the facts indicate that the taxpayer actually sold assets to the partnership. The taxpayer reported the funds received as income on its Federal Income Tax return. The partnership's Securities and Exchange Commission Annual Report for fiscal year ended January 29, 1994 referred to the transfer of assets as an "acquisition" by the partnership. Page 7 of that Annual Report states as follows, "Financial data for the twenty-six weeks ended January 29, 1994 reflects the effects of adjustments to historical asset values as required by the purchase accounting method, interest expense relative to the financing costs of the Acquisition, amortization of intangible assets related to the Acquisition. . . ." As income received from a sale, the taxpayer's income is subject to the gross income tax.

In the alternative, the taxpayer contends that if there is no contribution of capital to the partnership treatment, then the income must be treated as a distribution from a partnership. However, that does not comport with the federal law and regulations. Pursuant to IRC Sec. 707 (a)(2)(B), when a partner transfers property to a partnership and there is a related transfer of money to that partner from the partnership, it is a disguised sale rather than a contribution of capital or partnership distribution. The selling partner is required to recognize gain or loss on the disguised sale. Whether a transfer constitutes a disguised sale is a question of fact. Pursuant to 26 CFR Sec. 1.707-3 (c) and (d), such a transfer is presumed to be a disguised sale rather than a partnership distribution if the contributions and distributions are made within a two year period. The taxpayer and the partnership made the contributions and distributions within a two year period. Therefore, the Department finds the transaction to be a disguised sale. The taxpayer owes gross income tax on the income received in the transaction.

### **Finding**

The taxpayer's first point of protest is denied.

### **3. Tax Administration: Penalty**

#### **Discussion**

Taxpayer's final point of protest concerns the imposition of the ten per cent negligence penalty pursuant to IC 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2 (b) clarifies the standard for the imposition of the negligence penalty as follows:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code

or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to reach and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The taxpayer, a member of an affiliated group of corporations with a large tax department, clearly had Indiana income and was required by law to file an Indiana income tax return on that income. The taxpayer's failure to file a return was a breach of that duty and constitutes negligence.

### **Finding**

Taxpayer's protest is denied.